FEDERAL REVENUES:
CHANGING TRENDS AND THE
QUEST FOR TAX REFORM

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FEDERAL REVENUES: CHANGING TRENDS AND THE QUEST FOR TAX REFORM*

ISSUE DEFINITION

In 1970, federal revenues amounted to just over $15,000 million, which represented less than 17.2% of Gross Domestic Product (GDP). **Today the dollar amount of federal revenues is much higher, about $130,000 million, but as a percentage of GDP it has fallen to below 17%.** Yet in two decades much has happened to the amount of revenue that the federal government collects, the way in which it is collected and our understanding of the economic consequences.

This review examines the trends in federal revenues since the Carter Commission Report of 1967. It discusses the quest for higher revenues in the early 1970s and the reform measures of that decade which later substantially reduced government revenues, and goes on to the Conservative government's deficit reduction measures, which increased the level of taxes, and efforts at tax reform. This review also considers several analytical issues related to taxation.

BACKGROUND AND ANALYSIS

A. Changing Trends in Revenues by Source

Figure 1 portrays the pattern of federal revenues, expressed as a percentage of GDP, since fiscal year 1970-71. It is based upon the Public Accounts presentation of federal government transactions and comes from data presented in the 1994 and previous budgets.

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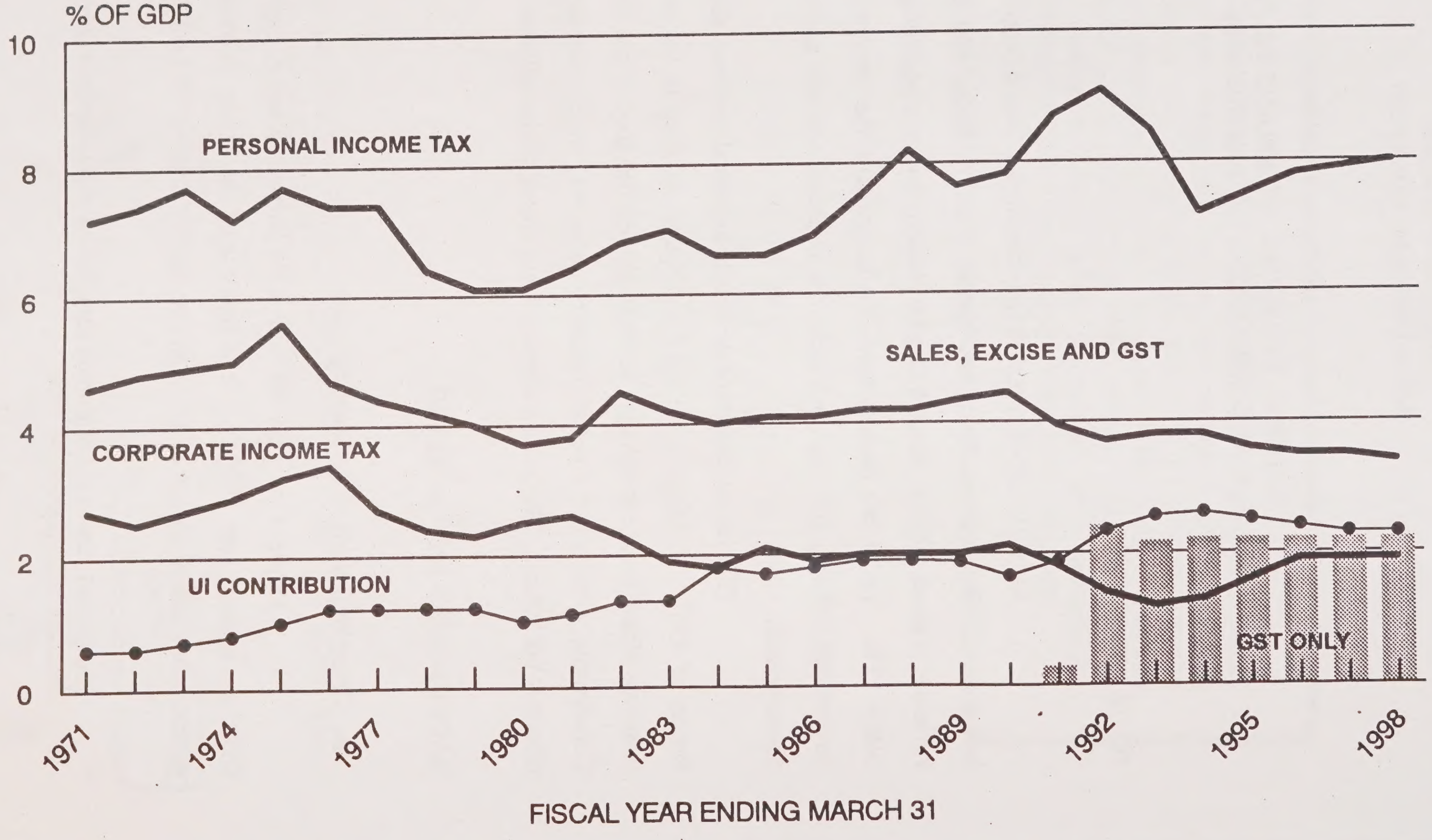
* The original version of this Current Issue Review was published in May 1990; the paper has been regularly updated since that time.

FIGURE 1

FEDERAL REVENUES
PUBLIC ACCOUNTS BASIS



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The largest source of federal revenues is the personal income tax (PIT). In fiscal year 1987-88, it reached just over 8% of GDP and exceeded 9% of GDP in 1992. It has now dipped well below that rate. At one point in 1979, personal income taxes accounted for only 6% of GDP. Indeed, one can argue that the latter half of the 1970s was a period of personal income tax reform which was eroded through the 1980s. Stage I reform of the Progressive Conservative government, on the other hand, had only a slight and shortlived impact on the increasing use of personal income taxes as a source of federal revenues. At almost 50% of federal revenues, the personal income tax is more important as a source of federal revenue today than it has been in the last two decades.

The second largest source of federal revenues has traditionally been sales and excise taxes. These taxes have varied enormously over time. In the early 1970s they amounted to close to 5% of GDP and provided almost 30% of federal revenues. By 1983, they were providing about 17% of federal revenues and amounted to 4% of GDP. They increased in importance slightly through the 1980s, when federal budgets made significant use of them as a source of revenue. The introduction of the Goods and Services Tax (GST) was expected to maintain this trend, although current receipts are less than expected.

Since 1983, corporate income taxes have been fairly constant at about 2% of GDP and 12% of revenues. Through the 1970s these taxes accounted for about 15% of federal revenues. **The recent recession, however, has had a very dramatic impact on corporate income tax revenues. By 1994 such revenues had fallen to 1.3% of GDP, accounting for only 8.1% of total revenues. The recovery of corporate profits has led to increases in tax revenues to more normal levels.**

Unemployment Insurance premiums have increased substantially, and now constitute the second most important source of federal revenues. **They now account for more than 14% of revenues and stand at about 2.3% of GDP.** In 1971, these premiums were less than half as important as they now are.

B. Federal Policy and Revenue Sources

1. The Carter Commission

An analysis of Canadian taxation cannot ignore the work of the Carter Commission (The Royal Commission on Taxation), which issued its report in 1967. That report was guided by several important and, at that time novel, precepts. These included the belief that fairness required the use of a comprehensive income base, including virtually all additions to wealth; that vertical equity (i.e., the notion that those with greater ability to pay should be subject to higher taxes) is best achieved via a progressive income tax with a maximum rate of 50%; that horizontal equity (i.e., the notion that those in similar economic circumstances should pay the same amount of tax) should be an important part of the tax system; and that taxes are paid by people, not corporations. This last precept called for a full integration of the corporate and personal income tax systems so as to avoid double taxation of corporate profits.

Additionally, the Commission favoured the use of the family, rather than the individual, as the taxpaying unit, since the former measured economic well-being better than the latter. In recognition that annual income is not a perfect interval for assessing taxes, five-year averaging was recommended. The Commission also favoured income taxes over other types of taxation, yet recognized that income tax rates would have to be far too high if they were to meet the needs of the government to raise revenue. This point is interesting, coming as it did at a time when government spending and taxation were far lower than today.

The Carter Commission was not silent on the manufacturers' sales tax; indeed it viewed that tax as a problem area. The suggested alternative closely resembled the options that the Conservative government more recently considered for Stage II of tax reform, i.e. some variant of a Value-Added Tax (VAT) or a national sales tax. In fact, however, the Commission considered the most efficient form of tax to be a retail sales tax, preferably to be administered by the provinces.

2. Tax Reform 1970s Style

The Carter Commission report met with only mixed success as a consequence of the vehement opposition that some of its recommendations attracted. In the end, one-half of capital gains were made subject to tax, rather than the full taxation that had been recommended. There

was also movement toward integrating the personal and corporate income taxes, with the implementation of a dividend gross-up and credit system. The top federal rate declined to 47%, implying an average total top tax rate of about 60%, down from the previous high of 80%. A new general tax-averaging provision was also introduced to offset some of the higher taxes that variable income produces in a world of progressive income taxation.

The major change to come out of the 1970s was the indexation of the personal income tax system, whereby the tax brackets and major exemptions were fully indexed to the rate of inflation, albeit with a lag. Inflation, especially a high rate of inflation, automatically increases the real income tax burden of taxpayers by pushing them into higher tax brackets even though their real incomes remain unchanged. The impact of this phenomenon, known as "bracket creep," is most pronounced on lower income individuals, because it is at these lower income levels that marginal taxes on income increase fastest.

A fully-indexed personal income tax system would take in a constant proportion of GDP in the event of no real income growth per capita. But personal income taxes as a percentage of GDP declined substantially from 1975 to 1980. Other changes which accounted for this decline in tax revenues included the $1,000 exemptions for investment income and pension income, the introduction of the Registered Home Ownership Savings Program (RHOSP) and the increase in the level of allowable contributions to Registered Retirement Savings Plans (RRSPs). During this period, the government also introduced and expanded the use of a tax reduction credit, which had the effect of removing lower income taxfilers from tax liabilities.

3. Tax Reform 1980s Style

In June 1986, the Minister of Finance, the Hon. Michael H. Wilson, released his White Paper on Tax Reform. The reform process was to comprise two distinct stages: the first to deal with income tax reform and the second to deal with sales tax reform. Stage I is now complete and Stage II is being debated in Parliament.

Income tax reform on the personal side did two things. It reduced the number of tax brackets from ten to three, and it converted a number of exemptions and deductions into non-refundable tax credits. It also lowered the top marginal tax bracket. On the corporate side, tax reform lowered marginal tax rates in general but it also removed a number of tax preferences

so that the base was broadened; in fact, the proportion of corporate income subject to tax increased from 72.4% on average to 84.1 %. This represents a 16% increase in the base.

This early stage of tax reform was to shift emphasis away from the personal income tax towards the corporate income tax and the sales tax. According to the White Paper on Tax Reform, personal income tax revenues were to decline by $10,300 million over four years, 1988-89 to 1991-92 inclusive. Over the same period, corporate income tax revenues were to increase by $3,845 million and sales tax revenues were to increase by $4,785 million. The sales tax increases would be maintained once the Goods and Services Tax was implemented.

The introduction of the Goods and Services Tax (GST) was initially seen as a move even further away from the use of the PIT as a revenue tool. Stage I of reform established three federal income tax rates: 17%, 26%, and 29%. As part of the Stage II reforms, the middle rate was to have been reduced by one percentage point, as suggested in the August 1989 technical paper on the GST and by as much as three percentage points as hinted at earlier. This idea has now been abandoned. Moreover, since 1985, federal budgets had introduced and increased personal income tax surtaxes independently of the tax reform process. These surtaxes were to have been eliminated with Stage II reform, but this idea has now also been abandoned.

The GST represents Stage II of reform. The government originally envisaged a 9% tax rate, but has subsequently chosen a 7% rate, in response to recommendations made by the House of Commons Standing Committee on Finance. The Canadian variant is not nearly as complicated as some European variants of the Value-Added Tax (VAT), but the federal government did not choose to follow the simpler New Zealand route with its broad base, limited exemptions and zero-rated products.

One tax change of the 1980s which is not usually viewed as a reform, was the decision to limit indexation of tax brackets and credits to the rate of inflation, less three percentage points. This loss of full indexation, ostensibly a deficit reduction measure, goes against the very grain of the developments of the 1970s by reintroducing an element of nonneutrality into the workings of the personal income tax system.

Tax reform by the Progressive Conservative government of Prime Minister Brian Mulroney cannot be viewed independently of the desire to control and reduce the deficit, a problem which plagued that government since it first came to power in 1984. The abandonment of full indexation, the introduction of a variety of surtaxes and the increased sales and excise tax rates are

all examples of this policy. Indeed, the GST was dubbed a new money machine by some commentators, and was viewed by the government as a necessary tool for deficit reduction.

C. Other Taxation Issues

1. Equity Considerations

Everyone thinks the tax system should be fair and equitable, yet the public has no generally accepted and well articulated definition of fairness to draw upon. It is easy to say that two individuals in similar economic circumstances should pay the same tax; it is far harder to determine when economic circumstances are the same if sources of income, age, family structure, etc. differ. It is easy to say that rich individuals should pay more tax than poor individuals; it is far harder to say how much more they should pay.

The concept of horizontal equity requires that similarly situated individuals pay the same tax, whereas the concept of vertical equity requires that the tax burden be linked to ability to pay. The latter concept receives far more prominence in policy debates than the former. Much of the tax incidence literature (studies purporting to show how the burden of taxation is linked to income) is concerned with vertical equity.

If we believe that a tax system should be "fair," over what time period do we judge its fairness? If we recognize that a day or a week or a month are inappropriate time periods, do not the same problems plague the annual estimation of tax equity? These questions are important because recent research indicates that the lifetime incidence of taxes differs substantially from its annual counterpart. Taxes viewed as regressive when considered on an annual basis may be proportionate or even progressive when viewed over an individual's lifetime.

The perception that there is a need for a minimum tax takes on a different dimension if the yearly test for equity is abandoned. Annual snapshots of the tax and income relationship indicate that some taxpayers have been able to use tax preferences to pay little or no tax in certain years, even though their apparent gross incomes are relatively high. Yet on a lifetime basis it will usually be apparent that such an advantage was temporary, with long-term taxes bearing the appropriate relationship to income. On a lifetime basis, no need for a minimum tax exists.

Revenue Canada has attempted to analyze the extent to which rich Canadians can consistently avoid paying tax; unfortunately the data are not current. Nevertheless they do demonstrate the temporary nature of this phenomenon. For example, between 1977 and 1981 inclusively, there were 896 instances of individuals with more than $200,000 of income (expressed in 1981 dollars) who paid no income tax. However, 84% of all such taxpayers avoided tax for only one year out of this five-year period; 12% avoided paying tax for two years, and no one was able to avoid paying any income tax for all five years.

The more important reason for abandoning annual accounting is the fact that lifetime calculations might give a better indication of the desirability of certain types of taxation. The relative income position of taxpayers changes over their lifetime. They start their working lives with relatively low incomes, little wealth and high rates of consumption. As they age, their incomes increase and their savings patterns change, and in the process they accumulate wealth. By the time they retire, their incomes are again relatively low and consumption is high, but now the accumulated wealth can be drawn upon for that purpose.

An annual snapshot of income distribution picks up two types of individuals, those for whom annual income is a good indicator of their lifetime income and those for whom it is not. There are, of course, rich individuals who will always be relatively rich and poor individuals who will always be relatively poor. But for many, the annual snapshot reveals only the temporary position in which individuals find themselves.

Lifetime tax incidence differs from annual tax incidence because it is less affected by temporary income fluctuations. The measure of fairness is whether those with low lifetime incomes pay less tax than those with high lifetime incomes (vertical equity) and whether individuals with the same lifetime income pay the same tax (horizontal equity).

A Canadian study of tax incidence on a lifetime basis indicates several areas in which our views of taxation need to be reconsidered. The apparent progressivity of taxes can change dramatically. Taxes usually thought of as progressive, such as the corporate and personal income taxes, continue to be progressive on a lifetime basis, but to a lesser extent than an annual view would suggest. Sales and excise taxes, which are normally viewed as highly regressive, turn out to be only moderately so and might even be considered proportional.

This view of tax incidence based on lifetime income might also be more reliable. Tax incidence studies are notorious for the extent to which the results can vary dramatically as the

basic assumptions change. Using lifetime income makes the results more robust in the sense that changing initial assumptions have less effect on final results.

2. Efficiency Considerations

What is the effect on the economy of $1 of additional tax revenue? The private sector obviously has $1 less to spend and the public sector $1 more, and macroeconomic discussions of tax policy rarely go beyond such simple arithmetic. Yet we know that the effects on the economy are far more pervasive.

In general, one dollar of tax revenue received costs the private sector more than one dollar because of a misallocation of resources in the economy. This is the concept of the welfare cost of taxation, whereby resource use is altered in such a way as to reduce the well-being of individuals and families. The higher the tax, the larger is this burden and it is conceivable that the welfare cost of taxation could far outweigh the revenues government received from a particular tax.

For example, the government might view a fountain pen excise tax as a particularly desirable tax. The chosen tax rate might be so high, however, that the sale of fountain pens in Canada fell to zero. No revenue would be received, yet clearly a welfare cost would be imposed. The price Canadians are willing to pay for fountain pens would normally make it profitable for someone to supply those pens. Consumers would see this as an efficient use of their income and producers would see this as an efficient use of their resources, but government intervention in the market via the excise tax might eliminate this opportunity for mutual benefit.

There is much public debate about who bears the burden of taxation, that is, the incidence of the direct revenue cost. This issue is dealt with elsewhere in this paper. There is very little debate, however, about these welfare costs of taxation and it is not at all clear that the distribution of these costs would be the same as the distribution of the direct costs. The fountain pen example used above is clearly extreme, but it does indicate an important aspect of taxation which incidence studies cannot tackle. Our conclusions about the apparent fairness of certain taxes might be incorrect.

There exists a welfare cost for all taxes because they all distort relative prices and consequently affect economic behaviour. Given the current tax system, the marginal welfare cost of additional taxes is very high; every time the government tries to raise an additional dollar, about forty to fifty cents disappear from the economy via a variety of disincentive effects. In high-tax jurisdictions such as Sweden, the marginal welfare cost is estimated to be many times the tax revenue collected.

After World War II, the federal government imposed very high marginal tax rates on the wealthiest of citizens, almost 100%. This has changed as the "disutility" of such confiscatory rates has become apparent; they raise small amounts of revenue yet have a high welfare cost.

Since the early 1970s, the federal government has continued this tendency of decreasing its highest marginal tax rate, from 46% in 1970 to 29% today. What high income earners have gained from the federal government, however, they have lost, to some extent, to provincial governments. For example, in 1970 the combined federal-provincial top rate in Ontario was about 59%. It grew gradually to about 62% in 1981 and has since declined to 44%. While the federal rate has declined by 37%, the Ontario rate has increased by 85%.

These marginal tax rates exclude the variety of surtaxes which are now imposed by the federal government and several provincial governments. At the federal level, a high income surtax was introduced in 1985; it was eventually converted to a 3% general surtax. (It should be noted that these surtaxes are imposed on taxes otherwise payable, not on income.) In 1989 we had a 5% general surtax and a 3% high income surtax. For 1990, the federal government proposes a 5% general surtax and a 5% high income tax. Thus in 1989 the total marginal federal tax rate facing higher income earners was 31.3%; it will increase to 31.9% in 1990, reversing much of the gain due to tax reform. Combined with the Ontario tax and the Ontario surtax, the "effective" marginal tax rate facing high-income Ontarians is now 48.5%.

High marginal tax rates for the rich are often favoured because they suggest that the tax system is progressive. But, as has been argued here, high tax rates have a high associated

welfare cost. The negative consequences of behaviour induced by high taxes can outweigh the beneficial, distributional consequences of a very progressive tax system.

3. Administration and Compliance Costs

Every time the government imposes a $1 tax on the economy, the private sector incurs costs well in excess of the amount of tax revenue transferred to the government. The previous section on efficiency dealt with an intangible and difficult-to-measure source of costs to the economy. This section deals with more obvious costs, those imposed on governments who collect taxes and those imposed on taxpayers who comply with these tax laws.

The costs of administering federal tax laws comprise the cost of running the Department of National Revenue, related costs incurred by the Offices of the Auditor General and the Comptroller General and any costs incurred by other levels of government who might collect federal taxes; for example, the government of Quebec is now collecting the federal GST in that province.

Taxpayers also incur costs. Employers must calculate and withhold the Personal Income Tax and a variety of payroll taxes on behalf of their employees. Employers must also determine the appropriate amount of tax payable on their own account. Financial institutions must print and distribute to clients information slips on their taxable income and tax preferences according to the Income Tax Act. Finally, individual taxpayers must prepare PIT returns, or hire someone to do this for them.

A recent study prepared for the Canadian Tax Foundation concluded that the cost in 1986 of administering and complying with the federal personal income tax, Canada/Quebec Pension Plan payments and Unemployment Insurance premiums totalled $5,500 million. Only 13% of this total was borne by the federal government, while 36% was borne by individuals and 51% by employers.

A recent study conducted for the Department of Finance examined 200 small businesses across the country to determine the size of their GST compliance costs. The study indicated that these costs are substantial. For firms with sales in excess of $1 million annually, they average 2.65 cents for every $1 of GST remitted. For firms with sales under $100,000 annually, the cost is 17 cents for every dollar remitted. According to the authors, there was virtually no

representation by firms with sales under $50,000 per year, the firms that would likely face exceptionally high costs.

The majority of participants expressed a desire for harmonization of the federal and provincial sales. Ironically, the strongest support came from businesses in Quebec, even though that province has come closest to harmonizing its tax with the GST.

4. The Case of the Corporate Income Tax

It is often claimed that the corporate sector does not pay its "fair" share of taxes and the picture painted in Figure I might reinforce such a view.
The effective rate varies substantially over time, peaking during a recession, when profits plummet. This is not particularly desirable in a tax base; the tax take is unpredictable and the effective tax rate is highest when the taxpayer is least able to pay.

Figure 2 presents another view of the Corporate Income Tax. The importance of this tax to the federal government is plotted against corporate profits as a share of GDP. The two series move very much in tandem. Indeed, 75% of the declining revenue share of the CIT can be accounted for by the decline in the importance of corporate profits.

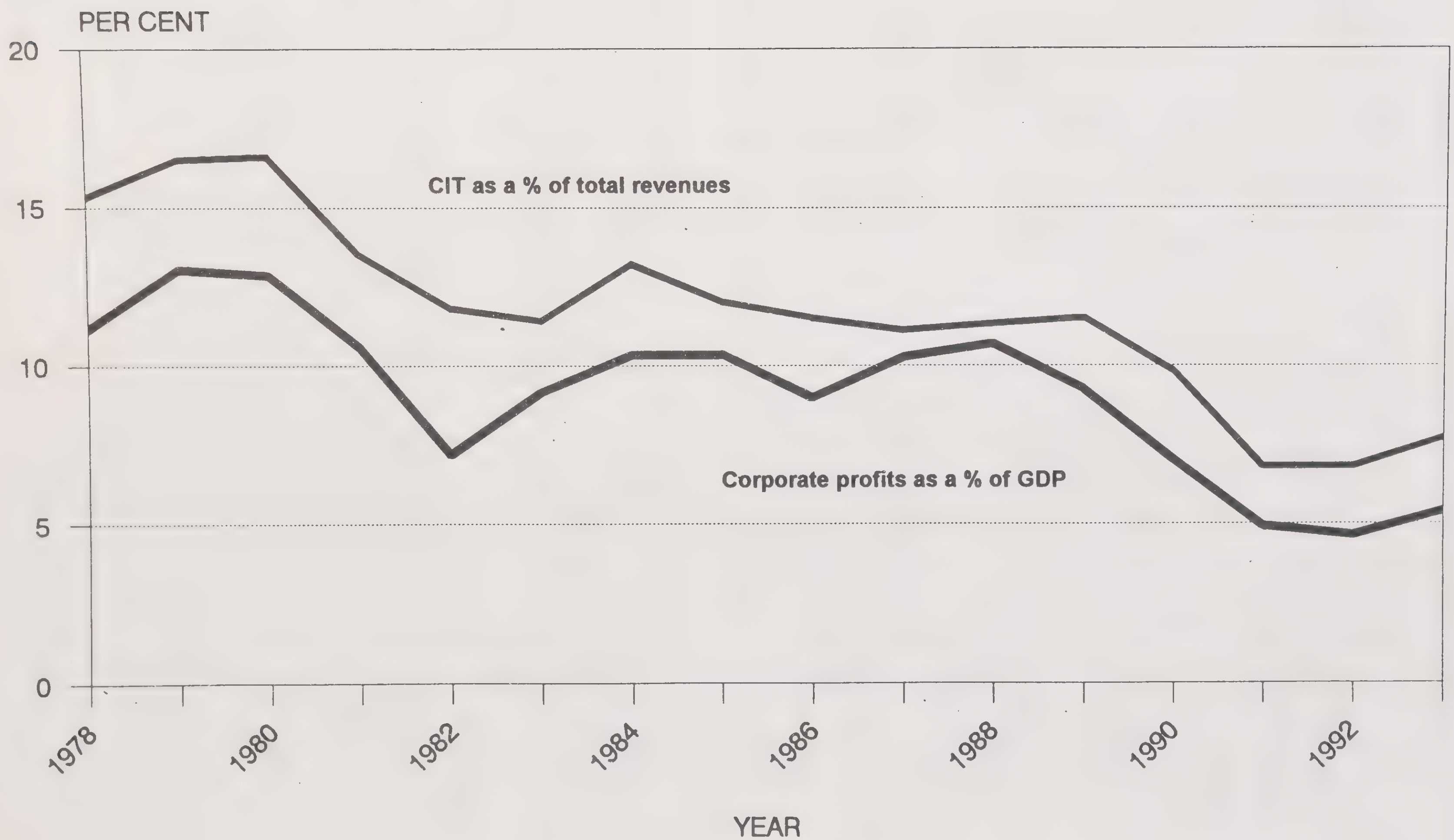
But when the question of corporate taxation arises, we often forget about the ultimate incidence of the tax. This matter is well put in the following quotation:

> Taxes are paid by people. They are not paid by corporations, partnerships, gifts, bequests, estates, trusts, sales, transfers, investments, savings, property, consumer expenditures, or any of the long list of things we usually list as subjects of taxation. Taxes imposed on these subjects are only a means of taxing people. (J. Harvey Perry, *A Fiscal History of Canada - The Postwar Years*, Canadian Tax Paper No. 85, Canadian Tax Foundation, Toronto, 1989, p. 286)

The matter of corporate tax incidence is not completely settled. But in calling for greater or lesser amounts of corporate taxation, policymakers must answer two questions: 1) whom do they wish to tax? and 2) where, in their opinion, does the incidence of the CIT lie?

FIGURE 2

CORPORATE INCOME TAX



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D. Federal Budgets and the December 1992 Economic Statement

The 1991 federal budget proposed little in the way of new taxes, with the following two exceptions, a significant hike in tobacco taxes, expected to raise almost $1,000 million the following year, and a $2,000 million increase in UI premiums.

The recession was expected to have little impact on federal revenues but a much greater impact on federal expenditures. In 1991-92, total revenues were forecast to fall by less than 1 % on account of the recession. While corporate income tax revenues were expected to be 20% below the previous year's forecast, increased personal income tax revenues were expected to offset most of this decline. When policy initiatives on the revenue side are taken into account, total revenues in 1991-92 were expected to be $2,500 million higher than was originally forecast in the 1990 budget.

The picture painted in the 1991 budget was completely revised in the 1992 budget. The poor performance of the economy was cited as the cause of a $5,700-million shortfall in revenues for 1992, growing to a $7,500-million shortfall in 1993. The largest absolute decrease is expected in the personal income tax, but the largest proportional decline will be in the corporate income tax.

Even this bleak picture proved to be excessively optimistic. For 1992-93, the Minister of Finance saw revenues as $8,000 million below the estimates presented in the 1992 budget - more than $15,000 million below the figure originally cited in the 1991 budget. In 1993-94, revenues were expected to be $10,000 million less than the projections in the 1992 budget.

The economic statement proposed no tax increases. Instead, it contained a variety of measures that would cost the government about $1,000 million in reduced revenues over a three-year period. Such measures included a one-year extension for the use of RRSPs for first-time home buyers, a moratorium on UI premiums for new small businesses and a cap on UI premiums for small business that increased employment. Small business firms were also granted a 10% investment tax credit.

E. The 1993 Federal Budget

The 1993 budget contained no new taxes and no new tax increases. It did include several tax measures which were expected to reduce federal revenues by $400 million over the next five years. These included an elimination of the annual limit on the use of the investment tax credit, new capital cost allowance rules for patents, an extension of the Scientific Research and Experimental Development Program to allow firms with taxable income in excess of $200,000 to earn refundable credits, and an amendment to regulations which would allow corporations enhanced write-offs of rapidly depreciating equipment such as computers.

But the real message of that budget pertained to the continuing decline in federal revenues as a consequence of the economy's weak performance. Revenues in 1992-93 were estimated to be $1,200 million less than predicted in the December 1992 Economic Statement and, consequently, $9,200 million less than predicted in the 1992 budget. Revenues for 1993-94 were also expected to fall short of the prediction made in the December Economic Statement.

Figure 1 shows the impact of the recession on corporate and personal income tax revenues. Corporate taxes fell dramatically through the recession and will recover only slowly through the rest of the decade. The same is true of personal income taxes, although the decline has been more moderate. Part of this decline is, however, illusory as the Child Tax Credit is treated as a tax expenditure assessed against the personal income tax even though it largely replaced the Family Allowance, which was treated as a program expenditure and accounted for over $2,000 million in spending.

The other significant trend in Figure 1 shows that UI premiums have overtaken the corporate income tax as a source of revenue. In 1993, UI premiums at about 2.5% of GDP were almost five times as high as they were in the first half of the 1970s.

F. The 1994 Federal Budget

The striking element in this budget was the recognition that federal revenues had been declining significantly over the past few years. In 1991-92, federal revenues equalled 18.1%

of GDP. In 1993-94, they were equal to only 16.1% of GDP, a very significant drop. With the exception of the reduction in the surtax announced in the 1992 budget, there were no significant tax policy changes to account for this drop.

One recent policy change affecting revenues was the amalgamation of the family allowance, refundable child tax credit and non-refundable dependent credit into a new child tax benefit. This reform changed some program spending into tax expenditure and hence resulted in a trend to lowered revenue. The reformed system cost the federal government more than was originally anticipated. At the time the system was proposed, costs were estimated at $4,900 million per year, up from the $4,500 million of the old system. The child tax benefit was, however, expected to cost $5,500 million in 1993-94, an amount to decline only slightly over the next two years. Since the program's benefits are determined by family income, the overall cost is sensitive to the state of the economy; thus, part of this increase could be attributed to the recession and slow recovery. The transition costs were also high, however. Because of the timing of benefit payments under the various child-related programs, the two systems overlapped in calendar year 1993. This overlap reduced revenues by $2,500 million over two fiscal years.

Other one-time and extraordinary events conspired to reduce revenues in 1993-94. Nevertheless, the relationship between the status quo level of revenues and GDP weakened substantially in that year. The budget pointed to specific economic circumstances that contributed to this decline, such as slow growth in personal incomes coupled with a relatively high indexation factor for the PIT. It was predicted that this relationship would strengthen to its pre-recessionary levels only after a couple of years.

G. "Confronting Canada's Deficit Crisis"

The report of the House of Commons Standing Committee on Finance proposed a total of $1,100 million in tax increases as part of a deficit reduction package. The tax measures would include an increase in the Large Corporations Tax, a tax on lottery and casino winnings in excess of $500, a 1.5¢ per litre tax on gasoline, and a reduction in the surtax applying to low- and

middle-income Canadians. This last measure was designed to make the income tax system slightly more progressive.

The Committee felt constrained from recommending even higher taxes. It noted the importance of corporate tax competitiveness with the United States. The proposed tax on lottery winnings, however, posed design and compliance problems; as well, provincial governments complained that it would be as much a tax on their lottery revenues as a tax on lottery winnings.

The Committee also recommended that the federal government increase its taxation of cigarettes as quickly as possible when circumstances warranted, that it consider reducing or eliminating the tax rebate offered to privately owned public utilities, and that it look into the possibility, and likely consequences, of taxing medical and dental benefits. The Committee also recommended further study of the tax treatment of retirement income and inheritance taxes.

As a contingency measure, in the event that the Committee's recommendations proved insufficient or were rejected in part, the Committee proposed a temporary deficit reduction surtax to be applied to all personal and business income. The report suggested that any such tax should contain a sunset clause.

H. The 1995 Federal Budget

In 1993, federal revenues were $121,452 million, only 7% higher than in 1990. While personal income tax receipts over that three-year period were up by 12%, to $58,300 million, corporate income taxes were down by 36% and total sales and excise tax revenues were down by almost 7%. The only other area of strong revenue growth, which in this case indicated poor economic performance, was that of premium revenues from unemployment insurance, which grew by 63%.

In 1994, revenues dropped precipitously to $116,000 million on account of the state of the economy, some one-time events and, most importantly, the introduction of the child tax benefit, which had the effect of converting some spending programs into tax expenditures and thus lowering revenues. The transitional costs associated with the move to the child tax benefit were also high. By 1995, revenues had increased to $125,000 million and were expected to remain in the range of 16.7% to 16.9% of GDP over the following two years. Over this period,

unemployment insurance became the second largest revenue source for the federal government, accounting for 15% of all revenues. With continuing improvement in the economy, however, GST revenues were expected to overtake UI premiums within two or three years. The personal income tax continued to grow in dominance, although part of this trend was masked by federal program and accounting changes.

The 1995 budget introduced little in the way of new tax measures. Excise taxes on gasoline and tobacco were increased, to raise $500 million and $65 million respectively each year. The large corporations tax and the corporate surtax were both increased quite substantially, and a special, temporary capital tax was imposed on large deposit-taking institutions. The financial institutions tax was expected to raise $100 million over two years and the first two taxes were expected to produce over $250 million in revenues each year.

At the personal level, the measures were described as tightening up the system and making it fairer. RRSP contributions were restricted slightly. The deferral of tax on business income was also restricted, to generate $300 million in annual revenues by 1998 while the tax treatment of family trusts was tightened up somewhat. All these revenue measures were expected to raise over $3,600 million over the following three years.

In addition, the government altered the timing of UI premium income so that premiums would not fall as fast as they would otherwise have done. It is the intention of the government to let the UI account amass a cumulative surplus of $5,000 million by the end of calendar year 1996, prior to letting premiums fall in line with expected UI benefits.

I. The 1996 Federal Budget

The 1996 federal budget contains no new taxes and no increases in tax rates. There is both good and bad news in this. For those who are seeking the end of the GST, the budget has nothing concrete to offer in terms of a new and, it is hoped, better tax. All it can offer is the promise that negotiations are continuing with the provinces to seek a reform and harmonization of the GST with provincial sales taxes. Tax rates have not been increased but changes to tax rules are being introduced which will affect the tax liability of individuals and corporations.

On the personal side, the changes can be categorized into three themes: retirement, education, and social development. The federal government is tightening up rules governing Registered Retirement Savings Plans, by denying the deductibility of fees, by controlling the limits on tax-assisted savings, and by reducing the age limit for maturing plans. The budget is also reducing the amount of tax assistance for investments in labour-sponsored venture capital corporations, by lowering the tax credit as well as the contribution limit. Because of the generous tax credits available to these investments, as well as their eligibility for RRSPs, they had become extremely popular and were representing a large drain on government revenues. The government is also allowing an unlimited carry-forward of unused RRSP room.

In recognition of higher tuition costs in the future; the government is providing more generous tax treatment of tuition and education costs; the credits are being increased, as is the amount that can be transferred. Registered education savings plan limits are being raised and the child care expense deduction is being altered to make it more beneficial to students with children.

On the social side, the tax system is to be more favourable to charitable donations, as recommended by the Finance Committee. Tax support for home care is to be raised and the Working Income Supplement is to be doubled in two stages to $1,000. This last measure is by far the most costly of the tax changes. Arguably the most controversial measure is the change in the tax treatment of child support. Under the new rules, the custodial parent will not pay tax on support payments received and the non-custodial parent will lose the deduction on payments made. The new rules are to apply to court orders or support agreements made as of 1 May 1997, or where existing agreements are changed on or after that date.

These personal tax measures will have little net effect on revenues. One reason is that the government feels it can obtain increasing revenues from the underground economy, as much as $100 million in 1989-99.

The government has also introduced corporate tax measures, the most notable of which is the extension of the temporary tax on large deposit-taking institutions (the banks).

Some very significant revenue items are not in the budget. As mentioned above, GST reform/elimination has not yet been achieved. In addition, the budget makes no statement on a substantial reduction of employment insurance premiums. Indeed, the statistical information in the budget suggests that such a reduction will not take place during the planning horizon for this budget.

In addition, the government is altering the timing of employment insurance premium payments to make it consistent with the practice for CPP premium payments. At present, weekly premiums are based on the lesser of maximum insurable earnings or actual earnings. As of January 1997, weekly premiums will be based upon actual weekly earnings; once the maximum annual premiums are reached, further premium payments will cease. Those who earn maximum insurable earnings or less will continue to pay premiums over a 52-week period. Those who earn more will pay their premiums over a shorter period of time. Someone earning $80,000 per year will pay all of his or her premiums in the first half of the year and pay nothing in the latter half.

This administrative change has no effect on total premium liabilities of employees and employers. But the timing change does affect the reported government deficit. By advancing premium payments, starting in 1997, the deficit for 1996-97 could be $1,500 million to $1,800 million less than stated in the budget. The impact on future fiscal years will be neutral. Nevertheless, this one-time administrative change could also reduce future debt servicing costs by about $100 million per year.

The budget also does not take into account proceeds from the sale of assets in 1996-97, in particular the sale of grain hopper cars and the air navigation system. The budgetary impact of these sales depends upon the amount received as well as the current accounting treatment of the assets. Newspaper accounts suggest that the gains from sale could be $1,500 million.

PARLIAMENTARY ACTION

Parliamentary involvement in the funding of government spending typically involves the examination and passage of legislation arising from government budgets, which are

usually presented once a year. The tax reform legislation that Parliament proposed in the latter part of the 1980s did not arise from budgets.

CHRONOLOGY

1962 -	The Royal Commission on Taxation was established under the Chairmanship of Mr. Kenneth Carter.
February 1967 -	The Carter Commission submitted its report. It proposed a dramatic restructuring of the *Income Tax Act* to broaden the base, lower maximum rates and integrate personal and corporate income taxes.
November 1969 -	The federal government tabled a White Paper on Tax Reform in response to the Carter Commission.
February 1973 -	The Minister of Finance introduced a permanent system of indexation for income tax brackets and exemptions.
November 1974 -	The Minister of Finance introduced the Registered Home Ownership Savings Plan (RHOSP), provisions to shelter pension income and dividend income from tax, and increased the personal income tax reduction.
August 1978 -	The government announced the introduction of a refundable Child Tax Credit to be delivered to families eligible to receive the family allowance. The CTC essentially delivers a targeted form of family allowance. It is not considered to be an expenditure in the usual sense of the word; rather it is a tax expenditure.
December 1979 -	The Conservative government's aborted budget introduced two notable tax-related measures: an increased tax on gasoline (18 cents per gallon) and a measure of mortgage interest and property tax relief for federal income taxpayers. Neither measure passed into law. That budget also contained, for the first time, an analysis of federal tax expenditures.
November 1981 -	The Minister of Finance attempted to eliminate a number of tax shelters but had to retreat in the face of much opposition.
June 1982 -	In line with the government's attempts to control inflation, indexation of the tax system was limited to 6% for 1982 and 5% for 1983.

October 1982 -	The Minister of Finance was presented with a proposal to shift the manufacturers' sales tax to the wholesale level.
April 1983 -	The flow through research and development tax credit was introduced; this would prove to cost the government far more in lost revenue than originally anticipated. Deductions for RHOSP contributions were made significantly more generous for purchasers of homes or appliances and furnishings in 1983. The deduction for child care expenses was also increased.
May 1985 -	Partial indexation of the tax system was introduced.
June 1986 -	The federal government tabled its White Paper on Tax Reform.
1988 -	Stage I of tax reform was implemented. The proportion of capital gains subject to tax was increased from one-half to three-quarters, starting in 1990.
August 1989 -	The government introduced its Technical Paper on the Goods and Services Tax.
December 1989 -	The government introduced Bill C-62, which would implement the GST.
April 1990 -	Bill C-62 passed third reading in the House of Commons and was subsequently sent to the Senate where it was referred to the Standing Committee on Banking, Trade and Commerce for study.
September 1990 -	The Standing Senate Committee on Banking, Trade and Commerce tabled its Report on Bill C-62 with a recommendation that the Senate reject the GST.
October 1990 -	The Senate passed Bill C-28, which provided for a special tax on OAS and family allowance benefits received by higher income Canadians. This bill also introduced a tax which had the effect of imposing a minimum tax on large corporations.
December 1990 -	The Senate passed Bill C-62 without amendment. It received Royal Assent within one week.
1 January 1991 -	The GST came into effect as planned. The Quebec retail sales tax on goods was harmonized with the GST, although the Quebec government offered a tax rebate on the purchase of books.

February 1991 - The government of the province of Saskatchewan agreed to harmonize its retail sales tax with the GST.

- The federal budget contained little in the way of tax initiatives. Taxes on tobacco products were increased substantially and UI premiums for employees were raised to \$2.80 per \$100 of insurable earnings. The employer's share was increased to \$3.92 per \$100 of insurable earnings.

December 1992 - The Minister of Finance tabled an economic and fiscal statement in the House of Commons which admitted to a net debt increase over two years of \$17,000 million over projections in the 1992 budget.

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